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ABSTRACT

The role of the federal government in authorizing tuition savings plans and the relationship of these incentives to more traditional student aid programs are examined. Most of the recent proposals to provide incentives for families to save for their children's education would allow tax breaks. For example, the Reagan administration proposal would allow families to set aside $1,000 per year, per student for college costs. The money saved would be deducted from a family's taxable income. Benefits from these plans are intended for lower and middle-income families; under the Reagan administration plan only families with incomes under $60,000 would be eligible. The tax benefit, though, would be greater for families in higher tax brackets. The benefits derived from savings incentives are not distributed on the basis of need at the time of college attendance. The major focus of current programs is to provide assistance to the lowest-income students. It is concluded that there are two serious limitations on tuition savings plans: their impact cannot be felt for many years, and they do not provide significant benefits to lower-income students. Additionally, these programs are complex and require a working knowledge of federal tax laws for families to understand them. (SW)

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INCENTIVES FOR TUITION SAVINGS

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EVALUATING STUDENT AID OPTIONS

ALTERNATIVES FOR FEDERAL INVOLVEMENT

As the level of debate on the upcoming reauthorization of the Higher Education Act intensifies, members of Congress, the Administration, and others can be expected to propose a wide variety of alternatives to the current array of federal aid programs. These proposals may be global in nature, or they may address specific components of the law or individual sectors of postsecondary education.

Reauthorization provides an excellent opportunity to review the effectiveness of the existing student aid programs and to devise new solutions to the problems of financing postsecondary education. Historically, each time the Higher Education Act has been reauthorized, the federal commitment to the student financial assistance effort has been renewed and strengthened. The Education Amendments of 1972 and 1976 were marked by the inauguration of new, innovative, and expanded programs to assist students; the Pell, Campus-Based, and State Student Incentive Grant programs were created in this manner. In 1980, Congress concentrated on building upon these earlier foundations; authorization levels were raised, the congressional role in the delivery of student aid was enhanced, and eligibility criteria were reevaluated. Once again, in the coming months, Congress must grapple with the question of how best to structure the federal role in providing assistance to postsecondary students.

This year, more than in past reauthorizations, Congress may look to research evidence to support certain proposals or to identify areas in need of attention. When Congress authorized the National Commission on Student Financial Assistance as part of the last reauthorization, it was trying to close what it viewed as an information gap between policymakers and the programs.

The National Commission produced nine reports and forty papers and provided information covering many of the most crucial questions concerning the national program of student financial assistance. The Commission also may have had one unintended effect; it raised the consciousness of many persons involved in the current reauthorization regarding the ability to use research as the basis for policy. The use of research to develop positions or to prove or disprove certain assumptions is not new, but it has never been used as extensively by policymakers and lobbyists as it is today.

Evaluating Student Aid Alternatives

Since the beginning of the current federal commitment to assist students in financing their post-secondary education, there have been a great many changes in the federal programs. Some of these have taken the form of vast new programs that radically alter the aid structure while others have represented little more than fine tuning of the existing system in order to improve its efficiency or effectiveness. Certain concepts consistently must be considered in evaluating the potential value of these changes as well as their future success or failure.

Most federal student aid is embodied in Title IV of the Higher Education Act of 1965 as amended. Title IV programs, which are the most costly and serve the most students, are the focus of the current reauthorization debate.

Proposals to add new student aid programs, to eliminate others, or to revamp the federal role can all be judged in a similar fashion to determine their feasibility and desirability. Such proposals should undergo three levels of scrutiny before they are either endorsed or written off:

The merits of the proposals must be carefully reviewed and the goals clearly defined.

Those who would benefit (and those who would not) should be specifically identified.

The ability of the proposals to blend in with existing programs and policies needs to be examined closely.

By acknowledging all of these levels of scrutiny, we can be in a better position to react to the many proposals that will be considered in the upcoming months. Additionally, by using these criteria as proposals are being developed, there is a greater chance to arrive at solutions that are grounded in fact, rather than assumption, and that are more likely to be perceived as reasonable, thoughtful, and able to achieve their intended purpose.

In recent years, there has been a growing concern that increasing college costs may be putting college out of reach for many American families. While there is a great deal of student financial aid available, very few middle- and upper-income families can qualify. This leaves them on their own as they seek to meet the costs of their children's college careers. Tuition savings plans, which offer tax incentives for this type of saving, may offer some help and hope to these families and may assist families in planning for their children's education. This paper examines the proper role of the federal government in providing these incentives as well as their relation to more traditional student aid programs.

It is our hope that this paper and the others in this series will add to

the body of knowledge on the federal role in aiding postsecondary students and that they will provide a framework for discussing, assessing, and judging the myriad of proposals that will be put before Congress and the community as part of the reauthorization exercise.

INCENTIVES FOR TUITION SAVINGS

Introduction

Families of all income levels and individual circumstances face the challenge of saving for postsecondary expenses. American families today are digging deeper into their pockets in order to keep pace with rising college costs and to afford the opportunity for their offspring to attend college. For families whose financial situations allow them the option, contributing to savings plans that will provide funds for their children's education has been an effective strategy for meeting future college costs.

The federal government expects all families that receive financial assistance to contribute a portion of their savings to defray postsecondary costs. Under the formulas used to determine eligibility for federal aid, students are also expected to contribute to college costs and save for college. Parents, of course may save over a considerably longer time than students. Many families open college savings plans long before the money will be needed, even upon the birth of a child.

In its recent pronouncements, the U.S. Department of Education has emphasized the role of students and families in the partnership that has developed in financing college education. Because the federal programs have not kept pace with inflation and rising postsecondary education costs, parents and students have had to turn to all available sources of money. A certain portion of current income is utilized, credit is secured in order to extend financial worth, and savings are used to meet basic needs or fill financial gaps.

In order to assist families in their savings efforts, proposals have been advanced to create federal programs offering incentives to savers. Proponents of such proposals argue that the federal government can use relatively inexpensive means to encourage parents to save for the future. They contend that if more parents saved and thus could contribute more towards college costs, there would be less need for federal or other public programs and the burden of college financing would be shared more evenly among all of the partners.

The federal government already provides savings incentives for many purposes via a number of vehicles. The most common of these programs allow families to shelter from taxes the interest gained on savings or to deduct the amount saved from their taxable income. Families may be penalized if they do not use these savings for their intended purpose. Applied to tuition savings, such a plan would allow families to set aside a maximum annual amount for the college costs of their children. The earlier parents

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open these accounts, the greater the total value of the tax break.

Plans such as these involve no actual expenditures by the federal treasury. Rather, their cost to the federal government is in the form of lost revenue that would have come from taxing the amount saved. In times of budgetary restraint, these plans appear much more attractive at first glance than programs that entail new government spending. The effects of foregone revenue are the same as new expenditures when it comes to narrowing the federal budget deficit, however, and this should be weighed carefully when judging the merits of savings incentives programs.

Additionally, federal tax laws provide certain incentives for parents to save towards the future educational costs of their children. According to a guide published by the American Association of State Colleges and Universities (AASCU):

> The wise, farsighted parent . . . can start building a college fund well in advance of the college years, using a creative and perfectly legal tax strategy that will add still more money to the fund.
>
> Current tax laws permit a variety of plans which will lead ultimately to a larger college fund. Basically, they involve investing money in the child's name rather than a parent's with tax on the income paid at the lower level of the child's income bracket instead of at the higher level of the parent's. A larger parental income means a greater difference in tax rates between parent and child, and more substantial benefits from using a tax-advantage plan.[1]

The AASCU guide describes a number of financial maneuvers that can assist families in saving for their children's college careers, including several types of trusts and interest-free loans.

Survey of Parental Savings

A survey conducted on behalf of the National Institute of Independent Colleges and Universities (NIICU) found that many parents have unrealistic notions regarding how much they need to save for their children's college education. Only half of the parents of children who are expected to go to college are currently saving, although two-thirds of them expect to dip into their savings to help meet college costs. The average family reported saving only $517 per year towards college costs.[2]

Julianne Still Thrift, NIICU's executive director, commented on the survey results:

> Clearly most parents are willing to pay for their children's education, and are making some effort towards that end. But their efforts are woefully inadequate in the face of today's college costs, and we know that costs will be much higher by the year 2000.[3]

The Reagan Proposal

The Reagan administration has advanced a specific plan to provide incentives for parents to save for college costs. This plan is designed to save families the taxes on interest earnings from funds saved for college. Under this proposal, parents could place as much as $1,000 per year into educational savings accounts. The amount of interest gained would be free from taxation for families with incomes under $40,000 per year. Wealthier families would be able to contribute reduced amounts to these accounts and those with incomes over $60,000 would not be eligible for such tax breaks. Savings in this type of account could then be used to support full-time undergraduate students between the ages of 18 and 26.

In its 1985 budget proposal, the Education Department argued that this type of savings incentive plan would not only be useful in helping families meet college costs, but it

> would make savings more attractive to lower and middle income families, and would . . . also add to the pool of savings available to individuals and businesses through lending institutions, thus contributing to economic growth.[4]

The Education Department estimated that, if implemented in the 1984 fiscal year, the program would cost the federal treasury $28 million in lost revenue in 1985, $137 million in 1986, and $295 million in 1987.[5] Costs for this program will continue to grow in future years.

Citizens League of Baltimore Proposal

The Citizens League of Baltimore has proposed a plan of its own designed to encourage savings for college, a plan under which families could deduct up to $2,000 per student annually from their taxable income. Once the student left school, the amount of tax-free savings used to pay college expenses would be considered as income and taxed by the federal government over a ten-year period. As part of its proposal, the Citizens League recommends that five percent of the contribution to educational savings accounts be set aside to help fund grants for low-income students. Amounts used for this purpose could be treated as charitable contributions by the saver.

New York State's PASS

According to a paper prepared by the Washington Office of the College Board, New York is the only state to have a plan in place to allow tax deductions for educational savings.[6]

The Parents' and Students' Savings (PASS) plan allows parents to deduct up to $750 annually from their state taxable income for contributions to an account for this specific purpose. The state also exempts interest savings from taxation and then

requires students to report the amount they received from these accounts as income once they leave school. Currently, only a small portion of New York State residents have taken advantage of the PASS program.

Evaluating Savings Plans

It is very difficult to estimate the long-range impacts of tuition savings options. Participation in these programs is left to the discretion of individual families. Families must have the foresight to open accounts when their children are very young in order to take full advantage of these plans and must be sufficiently well-off to set aside the maximum amount allowable. The ability of families to save is also subject to general economic conditions, with greater rates of savings occurring in better economic times.

In general, there are two serious limitations on tuition savings plans:

their impact cannot be felt for many years to come, and

they do not provide significant benefits to lower-income students.

These are important considerations when deliberating on the value of the federal role in providing incentives for college savings.

Additionally, these programs are quite complex in nature and require a working knowledge of federal tax laws for families to understand them. These plans are just one of many tax shelter options, and one of several that provide incentives for savings (Individual Retirement Accounts, or IRAs, for example). Families with limited amounts available for savings may not necessarily identify college savings as their top priority and opt not to take advantage of tuition savings plans. Critics of these proposals point out that many of the advantages they provide are no different than those already available through various provisions of the Internal Revenue Code (e.g., the Uniform Gifts to Minors Act).

As previously noted, current federal statutes provide families with several opportunities to receive a tax-break for college savings. But, according to Arthur Hauptman, these provisions benefit wealthier families more than needy ones.

In terms of the income distribution of tax benefits, tax provisions for families with children in college reach a much different group than do the student aid programs. The majority of tax benefits go to wealthier families; approximately 65 percent of benefits from existing tax provisions go to families with income above the median. Most of the proposed tax breaks would favor high income groups even more.[7]

Savings and the Federal Role

Tuition savings incentives are not currently an integral part of the federal

approach to assisting postsecondary students. While they are not incompatible with existing financial aid programs, the goals of tuition savings plans are not identical to those of the Title IV programs. The major focus of Title IV assistance is on the lowest-income students, those with the greatest need for assistance at the time of their enrollment in college. Savings plans will not benefit those persons to any great extent and are directed at anticipating financial need long before the tuition bills arrive.

The benefits derived from savings incentives are not distributed on the basis of need at the time of college attendance. Rather, eligibility for the incentives is determined according to the income of a family many years before the start of postsecondary schooling. Thus, although a family's income may be low enough to qualify for benefits at the time savings are being deposited, it may be substantially higher at the time the children begin college. Additionally, the tax breaks associated with these plans provide more money in tax savings to higher-income families in higher tax brackets than lower-income families.

Incentive plans for tuition savings represent a different approach to assisting students than the major federal student aid programs. In the short-term, savings incentives would have little or no impact on student access or the overall ability of students to meet postsecondary costs. In fact, this type of program might not have any significant impact for ten or more years. By then, families would be sufficiently aware of the program and its advantages and would have had the time to place a substantial amount in savings accounts--at least enough to make a serious dent in the costs of college attendance.

If tuition savings plans are to be endorsed by Congress, they must be viewed as a long-term investment in student financing and not an immediate cure for the financial problems of students considering postsecondary pursuits. Substantial revenue would be lost to the federal treasury for several years before benefits would accrue, making the plans vulnerable to political criticism and rendering them somewhat less attractive in times of budgetary constraints. Supporters of these programs would also have to counter criticism that the cost of tuition savings plans may limit the ability to fund fully the Pell Grant and Campus-Based programs because the total amount of federal money available for student assistance is limited.

Additionally, there are certain administrative obstacles that must be cleared before these plans could be considered seriously. Some form of annual reporting by savings institutions would need to be established in order to verify that the money claimed on the income tax form was actully deposited in a tuition savings account. Also, verification procedures would be needed to ensure that

funds withdrawn are spent only on education-related expenses. These verification procedures would have to be designed so that they place a minimal burden on banks to make the program attractive to savings institutions, without whose cooperation the plans could not be implemented. Coordination beteen the Internal Revenue Service and the U.S. Department of Education also would be crucial to the proper monitoring of these funds.

The preceding caveats notwithstanding, there are also a number of strong arguments in favor of establishing tuition savings incentives plans. Proponents of these plans contend that they might lead to a new design for student financing and that they would result in broadening and strengthening the national partnership in postsecondary financing. These plans are also seen as a way to ensure that parents maintain their responsibility to provide funds for the postsecondary education of their dependent children.

Tuition savings plans are attracting attention because they are being proposed at a time when Congress, the postsecondary education community, and families are searching for all means possible to assist students in meeting college costs. This is especially true among middle-income families who feel shut out from the current system; they are generally ineligible for federal aid or state grant programs and have few options available to them to help pay tuition bills. As federal program dollars are stretched and more of the money available is directed at the neediest students and families, those in the middle are left to their own devices to secure the means to pay for postsecondary costs. Tuition savings plans offer these families help and hope in their struggles to keep pace with rising costs. It is possible that savings plans might do a great deal to help ease the middle-income squeeze in postsecondary financing.

Once a tuition savings plan were operational, was widely publicized, and was embraced by many American families, it could indeed have an impact on the way families and students plan for college education. Savings incentives are also planning incentives, providing a tangible reason for families to sit down, discuss the future, and consider their ability to meet college costs in years hence. Of course, the earlier families do this, the better; but some might choose to wait until their offspring express some interest in continuing on to college, in junior high school years, for example. This might enhance the communication between parents and students and foster joint consideration of college options and goals.

If the more optimistic estimates of participation in tuition savings plans are realized, the plans may eventually help to stretch federal financial aid dollars. Increased savings, especially funds specifically designated to cover college costs, may help to reduce some families'

need for student aid by increasing their expected family contributions. Available savings would help offset need for Pell Grant and Campus-Based assistance and may even reduce public dependence on the Guaranteed Student Loan Program. For example, money contributed to postsecondary costs from tuition savings accounts might increase the level of parental contribution beyond the point where the family could qualify for Pell Grant or Campus-Based aid or the family might use tuition savings to close the gap beteen total cost and financial aid received, thus enabling them to avoid GSL borrowing.

Of course, the degree of this effect and actual amount of federal dollars that could be saved through reduced levels of financial need are topics for speculation. Further analysis of the long-term effects of savings incentives may be necessary in order to develop the most persuasive arguments in their favor. Given its limited short-term impact and potentially substantial cost to the federal treasury, Congress must be sure that future benefits would make their current investment worthwhile.

Summary

Several proposals have been offered recently to provide incentives for families to save in expectation of their children's postsecondary schooling. Most would allow certain tax breaks for families that save specifically for college.

The Reagan administration, for example, has introduced a tuition savings plan that would allow families to set aside $1,000 per year, per student for college costs. The money saved would be deducted from a family's taxable income. While these plans do not require annual federal appropriations, they cost the federal government money in the form of foregone tax revenues.

Benefits from these plans are intended for lower and middle-income families; under the Reagan plan only families with incomes under $60,000 would be eligible. The tax benefit, though, would be greater for families in higher tax brackets and, unlike the Title IV student aid programs, eligibility for benefits would be determined long before the start of postsecondary schooling.

It is difficult to evaluate the impact or effectiveness of tuition savings plans because results would not be achieved for ten or more years to come. In the long-term, it is hoped that tuition savings would increase the amount of family resources available to meet postsecondary expenses and, in turn, reduce the need for other forms of student aid. These plans might also provide much-needed relief for middle-income families that are not generally eligible for other federal student assistance programs.

Tuition savings plans offer a chance to achieve limited goals over a long period of time; in the

short-term, however, the federal government cannot anticipate gaining any measurable return on its investment. There is no hard data on which to base assumptions that these plans would be widely used or would result in substantial savings in other student aid programs. Added to this is the fact that these plans might not be effective in serving the most needy families. Thus, there is considerable reservation as to whether these plans would be worth the amount of tax revenues that would be lost to the federal treasury.

END NOTES

[1]Coopers and Lybrand, Early Planning for College Costs: A Guide for Parents (Washington, D.C.: American Association of State Colleges and Universities, 1984) 7-8.

[2]National Institute of Independent Colleges and Universities, A National Study on Parental Savings for Children's Higher Education Expenses (Washington, D.C.: NIICU, August, 1984).

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[4]U.S. Department of Education, The Fiscal Year 1985 Budget (Washington, D.C.: February 1, 1984) 42.

[5]Ibid.

[6]Arthur Hauptman, Tax Breaks for College (New York: College Board, 1984).

[7]Ibid., 21.